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No.

In the Supreme Court of the United States

OCTOBER TERM, 1980

UNITED GAS PIPE LINE COMPANY

Petitioner,

v.

FEDERAL ENERGY REGULATORY COMMISSION,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

STEPHEN A. WAKEFIELD
IRVING JACOB GOLUB
CECIL W. TALLEY
BAKER & BOTTS
3000 One Shell Plaza
Houston, Texas 77002
(713) 229-1489

Counsel for
United Gas Pipe Line Company

October 28, 1980

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QUESTION PRESENTED

Whether an order of the Federal Energy Regulatory Commission issued under the Natural Gas Act which deprives a natural gas company of any return whatsoever on one-fourth of its investment in assets devoted to the public service is unjust, unreasonable and confiscatory.

PARTIES

In addition to United Pipe Line Company and the Federal Energy Regulatory Commission, the parties to the proceeding in the court whose judgment is sought to be reviewed herein were Laclede Gas Company, Public Service Commission of the State of New York and United Municipal Distributors Group.

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

United Gas Pipe Line Company (United) petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Fifth Circuit in this case.

OPINIONS BELOW

The opinion of the court of appeals (App. A, *infra,* pp. A-1-26) is reported at 618 F.2d 1127. The order of that court denying rehearing (App. B, *infra,* p. B-1) is not reported. The opinion and order of the Federal Energy Regulatory Commission (Commission), Opinion No. 16[1] (App. C, *infra,* pp. C-1-28), and its Order Denying Rehearing (App. D. *infra,* p. D-1) are not yet reported.

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[1] United Gas Pipe Line Company, "Opinion and Order Affirming in Part Initial Decision," Docket Nos. RP75-30, RP74-20 and RP74-83.

JURISDICTION

The judgment of the court of appeals was entered on June 12, 1980, and a timely petition for rehearing was denied on July 30, 1980. The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1) and Section 19(b) of the Natural Gas Act, 15 U.S.C. § 717r(b).

STATUTE INVOLVED

Section 4(a) of the Natural Gas Act, 15 U.S.C. § 717c(a), provides:

> "All rates and charges made, demanded, or received by any natural-gas company for or in connection with the transportation or sale of natural gas subject to the jurisdiction of the Commission, and all rules and regulations affecting or pertaining to such rates or charges, shall be just and reasonable, and any such rate or charge that is not just and reasonable is hereby declared to be unlawful."

STATEMENT OF THE CASE

United filed for three separate rate increases with the Commission[2] under Section 4 of the Natural Gas Act covering rates in effect for the period from April 6, 1974, to December 14, 1975. The parties agreed that United's total capitalization for each period was slightly in excess of $400 million, which was divided roughly evenly between debt and equity. There was no dispute regarding the return United should be allowed on that portion of its assets which represented the debt portion of its capitalization. The parties, however, were in sharp disagreement over

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[2] The term "Commission" refers to respondent subsequent to October 1, 1977, and to its predecessor agency, the Federal Power Commission, prior to that date.

whether United should be permitted any return on that portion of its assets represented by $100 million of the equity portion of its capitalization.[3]

In March 1974 Pennzoil Company (Pennzoil) spun off United, its wholly owned subsidiary, and, in a related transaction, received $100 million in preferred stock which United had declared as a dividend from its common equity accounts. The Commission instituted an investigation which resulted in a spin-off settlement agreement under which, *inter alia,* Pennzoil returned the preferred stock to United for rescission on December 30, 1975. Simultaneously, Pennzoil returned $15.1 million in dividends which United had paid on the preferred stock while it was outstanding, and United returned $15 million in equity contributions which Pennzoil had made in March 1974.

The Commission rejected United's position that the $100 million in rescinded preferred stock should be treated as common equity for purposes of establishing a return allowance and instead determined to classify this portion of United's capital as preferred equity. The Commission then refused to permit United to earn any return on that portion of its total investment represented by this $100 million, or one-quarter of United's total capitalization. United's argument that it was required to return $15 million in equity contributions to Pennzoil in order to receive back approximately $15 million in preferred dividends was rejected by the Commission, which reasoned that because of the return of those dividends the net cost to United of the preferred stock was zero.

Subsequent to the Commission's denial of its petition for rehearing, United timely sought judicial review under Sec-

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[3] The appropriate rate of return to be allowed on that portion of United's assets represented by common equity, disputed below, is not in issue here.

tion 19(b) of the Natural Gas Act. The court of appeals affirmed the orders of the Commission.

The court held that Pennzoil, by agreeing to the spin-off settlement, bore the entire cost of the preferred stock for this period. Therefore, $100 million in United's capitalization was cost-free to United and no return whatsoever should be allowed on this $100 million of United's invested capital during these rate periods.

REASONS FOR GRANTING THE WRIT

Petitioner recognizes that the Court rarely reviews cases in which an administrative agency has established the rate of return which a regulated company may earn. In the leading case interpreting the Natural Gas Act, the Court promulgated the standard for judicial review of rate proceedings:

> "It is not theory but the impact of the rate order which counts. If the total effect of the rate order cannot be said to be unjust and unreasonable, judicial inquiry under the Act is at an end." *FPC v. Hope Natural Gas Co.*, 320 U.S. 591, 602 (1944).

This case, however, is not a traditional appeal from an agency order in which the company complains that it has been denied an adequate return. It does not involve judgmental or factual issues which an agency is granted broad discretion to resolve. Petitioner here seeks review of an order which is totally at odds with the clear legal principles under which the natural gas industry has been regulated for decades. Contrary to the long-standing precedent that a regulated company must be given an opportunity to earn a return on its total investment which is dedicated to public service, the Commission has refused to permit petitioner any return whatsoever on one-fourth of its dedicated investment.

The Court in *Bluefield Waterworks & Improvement Co. v. Public Service Commission,* 262 U.S. 679, 690 (1923), ruled that "rates which are not sufficient to yield a reasonable return on the value of the property used at the time it is being used to render the service are unjust, unreasonable and confiscatory." The principle that a regulated company must be given an opportunity to earn a just and reasonable return on its total investment dedicated to public service was thought to be so well settled that citation was scarcely necessary.[4]

This principle, applied initially to utility rate proceedings, has been followed by the Court in its review of regulatory orders arising under the Natural Gas Act. In *FPC v. Natural Gas Pipeline Co.,* 315 U.S. 575, 590 (1942), which sustained the constitutionality of that act, the Court considered the inclusion of certain items in the company's rate base and found that, if rightly included, the company would have been entitled to earn a fair return upon their value. The Court further held that under the Congressional standard prescribed by this statute, the Commission must establish a rate "which is not confiscatory in the constitutional sense." 315 U.S. at 585.

In the face of this long-established regulatory maxim, the Commission assigned a cost of zero on $100 million (approximately one-fourth) of United's capitalization which was represented by the returned preferred stock, theori-

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[4] 262 U.S. at 690-91. *See also Transcontinental Gas Pipe Line Corp. v. FPC,* 518 F.2d 459 (D.C. 1975) ("It is well settled that to deprive public utility investors of a return on property currently dedicated to public use constitutes an unconstitutional confiscation of property." 518 F.2d at 464, *citing West Ohio Gas Co. v. Public Utils. Comm'n,* 294 U.S. 63 (1935); *United Rys. v. West,* 280 U.S. 234 (1930); *Bluefield Co. v. Public Serv. Comm'n,* 262 U.S. 679 (1923); *Galveston Elec. Co. v. Galveston,* 258 U.S. 388 (1921)).

zing that the rates thus established to consumers would reflect "United's actual cost for the preferred stock." In the Commission's view, the consumer would be the beneficiary of Pennzoil's return of $15 million in dividends on the preferred stock and the common equity owner would not be affected. App. C, *infra,* p. C-16. Opinion No. 16 ignores the fact that the Commission's action deprives United of any return on one-fourth of its investment in rate base represented by the $100 million in preferred stock.

Upon judicial review the court below dismissed United's contention that the Commission had denied it the opportunity to earn a return on a substantial portion of its investment dedicated to public service. The court rejected the concept that rates are to be determined on the basis that a regulated company is entitled to earn a return on these assets. This established principle would be replaced by the novel theory propounded by the court that the purpose of a return is not to permit the corporation to earn money on its investment in assets dedicated to public use, but rather "to repay its creditors and then for the benefit of its owners." App. A, *infra,* p. A-21.

In justification of the denial of any return on one-quarter of United's invested capital, the court below held that Pennzoil had agreed to earn no return on the $100 million investment. The court thus concluded that United had the cost-free use of $100 million worth of assets reflected in the preferred stock and was entitled to no return thereon (App. A *infra,* p. A-22), despite the uncontroverted facts that (1) the preferred stock issued as a dividend to Pennzoil was derived from United's capital surplus and retained earnings accounts; (2) the issuance of the preferred stock affected neither United's assets nor its total capitalization, but merely reclassified $100 million from common equity to preferred equity; and (3) Pennzoil, having given United nothing for the $100 million preferred stock issue, retained

both the stock and the dividends which United paid on it until the implementation of the spin-off settlement. There is no conceivable theory under which Pennzoil could have borne the cost of $100 million and, in fact, the court offers none. On the contrary, Pennzoil was the recipient, at no cost to it, of $100 million out of United's equity capitalization and the dividends which United paid on the preferred stock until their return. The court's fallacious reasoning cannot disguise its refusal to permit United any return on one-fourth of its dedicated assets.

This Court has long recognized the guiding principle that rates which are not sufficient to yield a reasonable return on the value of the property used at the time it is being used for public service are confiscatory, without regard to the manner in which that property was acquired:

> "Constitutional protection against confiscation does not depend on the source of the money used to purchase the property. It is enough that it is used to render the service." *Board of Utility Commissioners v. New York Telephone Co.*, 271 U.S. 23, 31 (1926).

These assets were the product of efforts by United's management in the past to reinvest shareholders' property, capital surplus and retained earnings, in the company. The holding of the court below would confiscate United's assets, appropriating them for the benefit of the consumer, an effort which exceeds the authority of regulatory bodies.

> "Earnings reinvested in the enterprise become equity capital no less than other capital contributions do, and are entitled to consideration in the calculation of fair return to the same extent as other capital investment is. Reinvested earnings, like other components of investors' equity, are risked in the business, and in the same degree warrants compensation for the risk." *Powell v.*

Washington Metropolitan Area Transit Commission, 485 F.2d 1980, 1085 (D.C. Cir. 1973).

The court below, rather than reviewing the regulatory orders in the context of the right of the regulated company to earn a just and reasonable return on its assets, would require an investigation of (1) the expectancy of return by investors and (2) the risk which those investors seek to undertake. App. A, *infra,* p. A-24. Judicial oversight through the analysis of investor throught processes is an impermissible deviation from the standards established by this Court in *Hope.* The reviewing process followed by the court below fails to provide equity returns "commensurate with returns on investments in other enterprises having corresponding risks" and calculated to be sufficient to assure confidence in the financial integrity of the company whose rates are being regulated. 320 U.S. at 603.

The court below concludes that if all of a utility's capital were the gift of a "munificient investor," then the company would be entitled to no return on that investment, but could only recover its out-of-pocket costs. App. A. *infra,* pp.A-22-23. No legal precedent exists to permit such confiscation of private property without compensation. With the sole exception of capital contributed to a regulated company by its customers[5], the source of the capital is immaterial to a determination of the return to be allowed on the company's dedicated assets. The court below has adopted new standards for reviewing establishment of a return allowance by a regulating agency, rejecting a half century of decisions by this Court which were designed to enhance the ability of regulated companies to maintain credit and attract capital.

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[5] *E.g., Alabama-Tennessee Natural Gas Co. v. FPC,* 359 F.2d 318, 340-41 (5th Cir.), *cert. denied,* 385 U.S. 847 (1966).

The decision of the court below, in affirming the orders of the Commission, has deviated substantially from prior opinions of this Court which have established standards of review to assure that regulated companies are given the opportunity to earn a return on their total investment dedicated to public service. The legal guideposts which the court below would propose would make review of agency decisions meaningless and would inhibit capital attraction because of the uncertainty which necessarily would follow. This Court should not allow that decision to stand.

CONCLUSION

For the foregoing reasons, the petition for a writ of certiorari should be granted.

Respectfully submitted,

STEPHEN A. WAKEFIELD
IRVING JACOB GOLUB
CECIL W. TALLEY
BAKER & BOTTS
3000 One Shell Plaza
Houston, Texas 77002
(713) 229-1489

Counsel for
UNITED GAS PIPE LINE COMPANY

Appendix A

UNITED GAS PIPE LINE COMPANY,
Petitioner,

v.

FEDERAL ENERGY REGULATORY COMMISSION,
Respondent.

No. 79-1903.

UNITED STATES COURT OF APPEALS,
FIFTH CIRCUIT.

June 12, 1980.

Appeal was taken from an opinion of the Federal Energy Regulatory Commission determining the reasonableness of rates for gas pipeline company during three rate periods. The Court of Appeals, Charles Clark, Circuit Judge, held that: (1) for rate-making purposes, gas utility's capital structure was properly treated as it actually existed during locked-in period rather than as it was refashioned by spin-off settlement, and, therefore, the structure was properly held to include preferred and common equity, which was subsequently rescinded and returned pursuant to the spin-off settlement, and (2) for rate-making purposes, gas utility was not entitled to recover cost of its preferred equity, where such equity was rescinded and dividends paid thereon were refunded pursuant to spin-off settlement, since under such circumstances there was no actual cost.

Affirmed.

1. Gas — 14.5(6)

Party seeking to overturn a rate order promulgated under Natural Gas Act undertakes heavy burden of making a convincing showing that it is invalid because it is unjust

and unreasonable under the circumstances. Natural Gas Act, § 1 et seq., 15 U.S.C.A. § 717 et seq.

2. Gas — 14.5(6)

Courts are without authority to set aside any rate order promulgated under Natural Gas Act which is within a zone of reasonableness. Natural Gas Act, § 1 et seq., 15 U.S.C.A. § 717 et seq.

3. Gas — 14.4(10)

Overall rate of return on capital of gas utility is fair and reasonable if rate of return on each of various types of capital on gas utility's balance sheet is reasonable.

4. Gas — 14.4(10)

For rate-making purposes, gas utility's capital structure was properly treated as it actually existed during locked-in period rather than as it was refashioned by spin-off settlement, and, therefore, the capital structure was properly held to include preferred stock and common equity, which were subsequently rescinded and returned pursuant to the spin-off settlement.

5. Gas — 14.4(10)

Rate of return on each class of capital of gas utility must be sufficient for utility to recover its cost on such class. Natural Gas Act, § 1 et seq., 15 U.S.C.A. § 717 et seq.

6. Gas — 14.4(10)

Fair and reasonable rates of return on equity capital of gas utility may be set without reference to standards of "comparable earnings" and "capital attractiveness." Natural Gas Act, § 1 et seq., 15 U.S.C.A. § 717 et seq.

7. Gas — 14.4(10)

Fifteen percent rate of return on equity capital of gas utility was fair and reasonable, where during applicable period utility had thin equity ratio due to existence of preferred equity, even though such equity was subsequently rescinded pursuant to spin-off settlement, utility had difficult supply outlook, adverse economic conditions prevailed, shareholders could no longer look to corporate parent of utility to satisfy their investment expectations because of spin-off arrangement, and government was investigating the spin-off arrangement, heightening the risk. Natural Gas Act, § 1 et seq., 15 U.S.C.A. § 717 et seq.

8. Gas — 14.4(1)

When a utility enjoys an unexpected benefit that is not associated with risk sought to be undertaken by investors, regulating authority may properly determine that such benefit should accrue to consumers rather than to investors.

9. Gas — 14.4(10)

It was within informed discretion of regulating authority to order that consumers gain benefit of gas utility's low-cost capital, which resulted from spin-off settlement whereby gas utility's preferred equity was rescinded and dividends paid thereon were refunded, rather than letting utility charge as much as would have been appropriate had such capital been acquired in the market and paid for at market's rate. Natural Gas Act, § 1 et seq., 15 U.S.C.A. § 717 et seq.

10. Gas — 14.4(10)

For rate-making purposes, utility was not entitled to recover cost of its preferred equity, where such equity was rescinded and dividends paid thereon, were refunded pursuant to a spin-off settlement, since under such circum-

stances there was no actual cost. Natural Gas Act, § 1 *et seq.*, 15 U.S.C.A. § 717 *et seq.*

Petition for Review of an Order of the Federal Energy Regulatory Commission.

Before CHARLES CLARK, RONEY and GARZA, Circuit Judges.

CHARLES CLARK, Circuit Judge:

In this appeal we are asked to review an opinion of the Federal Energy Regulatory Commission ["Commission"] that determined the reasonableness of rates for the United Gas Pipe Line Company ["United"] during three rate periods. We find that the Commission's action is supported by the facts and by sound ratemaking principles. United has not demonstrated that the Commission's rate order is unjust or unreasonable. We affirm.

I

United became a wholly-owned subsidiary of the Pennzoil Company in 1968. Pennzoil, a natural resource company, engages in oil and gas exploration and production, in processing, refining, and marketing oil and gas and refined petroleum products, and in mining. United owns and operates an extensive interstate pipeline system from which it makes sales of natural gas to other pipelines, to city gate customers, and to direct industrial users.

In 1974, Pennzoil began to believe that the Federal Power Commission's[1] regulatory treatment of affiliated producers and pipelines was putting it at a competitive disadvantage. Accordingly, Pennzoil determined to consummate several

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[1] On October 1, 1977, the Federal Power Commission ceased to exist and most of its regulatory responsibilities were transferred to the Federal Energy Regulatory Commission. Both are referred to herein simply as the Commission.

financial transactions by which it would disaffiliate or "spin off" United. On March 13, 1974, United declared as a dividend to its parent one million shares of 9¾% Cumulative First Preferred Stock with a par value of $100 per share. This stock was placed in a voting trust pending sale to third parties. The next day, Pennzoil declared a dividend to its shareholders of all the common stock of United. Pennzoil simultaneously made a $15 million equity contribution to United by forgiving $10 million of debt and $5 million of income tax liability. In addition, United agreed to establish a purchase fund and a sinking fund which, under certain conditions, would result in United's repurchase of the preferred stock.

After learning of these transactions, the Commission ordered an investigation of the spin-off on May 14, 1974, pursuant to its authority under section 14 of the Natural Gas Act, 15 U.S.C. § 717m. The Commission wanted to investigate the impact of the spin-off upon United's financial strength and current and future gas supply and to determine whether these transactions violated sections 7(b) and 12 of the Natural Gas Act, 15 U.S.C. §§ 717f(b) & k.

Some months later, hearings commenced before Presiding Administrative Law Judge Zwerdling at which Pennzoil, United, the Commission Staff, and a number of intervenors presented evidence. Once the facts had been developed on the record, the active parties, with the exception of the Commission Staff, entered into settlement negotiations that culminated in a proposed agreement. After further hearings, in which the Commission Staff did participate, Judge Zwerdling recommended the approval of the spin-off settlement. On November 28, 1975, the Commission affirmed the initial decision, approved the settlement, and terminated the investigation. The Commission's Order became final and no longer subject to judicial review on December 29, 1975.

Under the terms of the Settlement, the entire transaction was to be rescinded by cancellation of the stock and refund of all funds paid by both parties. Accordingly, on December 30, 1975, Pennzoil transferred to United the entire $100 million of preferred stock and returned to United $15,139,583, representing all amounts received as dividends on that stock. At the same time, United cancelled the preferred stock certificates and returned to Pennzoil the $15 million equity capital contribution. Thus, by December 30, 1975, United was returned to the status quo of the period prior to March 13, 1974, with the exception that United was now independent of Pennzoil.

During the pendency of the spin-off, investigation, and settlement, United had filed three successive rate increases for jurisdictional service under section 4 of the Natural Gas Act, 15 U.S.C. § 717c. Pursuant to its powers under that section, the Commission suspended each of the filings for the statutory period; at the end of each period, the rates became effective subject to refund. The dates for these three locked-in periods roughly coincide with the period from the spin-off to its settlement. The rate filed in FPC Docket No. RP74-20 was in effect from April 6, 1974, to October 31, 1974; the rate filed in FPC Docket No. RP74-83 was in effect from November 1, 1974, to May 19, 1975; the rate filed in FERC Docket No. RP75-30 was in effect from May 20, 1975, to December 14, 1975.

The Commission consolidated the proceedings in Docket Nos. RP74-20 and RP74-83, which involved the same facts, and in Opinion No. 815 approved a settlement that the parties had certified to it. Under the terms of that settlement, which applied to the period from April 6, 1974, to May 19, 1975, United was entitled to a stipulated overall rate of return of 10.15%, based on a cost of debt of 8.9%,

a cost of 9.75% on the preferred stock, and a return of 14% on common equity.[2]

In the meantime, proceedings were continuing in Docket No. RP75-30, concerning the third part of the locked-in period, May 20 to December 14, 1975. After a settlement of the majority of the issues in the case, Presiding Administrative Law Judge Lande held hearings and, on October 14, 1977, rendered an initial decision. He decided that the spin-off settlement could affect but did not purport to determine the appropriate rate of return. Therefore, the subsequent rescission of the preferred stock and the return of the dividends did "not mean that the preferred stock is to be considered never to have existed." In Judge Lande's view, the $100 million was properly classified as preferred stock for ratemaking purposes. Treating the capital structure as comprising $212,487,000 in debt, $100 million in preferred stock, and $93 million in common equity, he found that a return of 15% on that common equity "represents a rate of return for this [locked-in] period sufficient to allow United to continue to attract capital and to maintain its financial integrity." As for the preferred stock, Judge Lande found that United had enjoyed a "double recovery": the rate in effect during the period had permitted it to collect from its ratepayers sufficient funds to pay the 9.75% dividend, but pursuant to the spin-off settlement it had recovered those dividends back from Pennzoil. He there-

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[2] The settlement in the consolidated docket, referred to as RP74-20/83 provided for the following capitalization and returns:

	Amount (000's)	Ratio	Cost	Weighted Cost
Long-Term Debt	$224,681	54.96%	8.9 %	4.891%
Preferred Stock	100,000	24.46%	9.75%	2.385%
Common Equity	84,129	20.58%	14.00%	2.881%
	$408,810	100.00%		10.157%

fore allowed a zero rate on the preferred equity to prevent United from recovering the cost of the dividends a second time. The cost of debt was agreed to be 7.92%. Thus the overall rate of return allowed was 7.59%.[3]

Ostensibly in light of Judge Lande's treatment of the cost of the preferred stock, which was at variance with the Commission's treatment of the same situation in the earlier docket, RP74-20/83, the Commission on rehearing issued Opinion No. 815-A, in which it decided to reopen the question of the reasonableness of the rate of return and to defer action on that question pending resolution of the rate of return issue in RP75-30, which United by this time had appealed to the Commission.

In Opinion No. 16, issued July 3, 1978, the Commission affirmed the Initial Decision of Judge Lande. It agreed that the $100 million was properly classified as preferred equity that should be costed at zero. The Commission, however, did not employ Judge Lande's reasoning that the preferred stock had an actual cost of 9.75% but had to be costed at zero to avoid a double recovery. Instead, it held that the net cost of the preferred stock was in fact zero because the dividends paid out by United were subsequently returned to United. The Commission affirmed the trial court's determination that a rate of return of 15.00% on $93 million of common equity was reasonable under the circumstances.

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[3] Judge Lande allowed the following capitalization and returns in RP75-30:

	Amount (000's)	Ratio	Cost	Weighted Cost
Long-Term Debt	$212,487	52.41%	7.92%	4.15%
Preferred Stock	100,000	24.67%	–0–	–0–
Common Equity	92,910	22.92%	15.00%	3.44%
	$405,397	100.00%		7.59%

The Commission applied similar reasoning to Docket No. RP74-20/83. It costed the preferred stock at zero; the return on common equity remained at the stipulated 14.00%; the cost of debt was unchanged. The overall rate of return on that docket became 7.77%[4]

United appeals from the Commission's order, urging that the spin-off settlement requires the $100 million to be treated either as common equity and costed accordingly or as preferred stock at a cost of 9¾%. The net effect of the Commission's rate order, it contends, is to deny the company the opportunity to earn a just and reasonable return.

II

[1, 2] A party seeking to overturn a rate order promulgated by the Commission under the Natural Gas Act undertakes "the heavy burden of making a convincing showing that it is invalid because it is unjust and unreasonable under the circumstances." *FPC* v. *Hope Natural Gas Co.*, 320 U.S. 591, 602, 64 S.Ct. 281, 288, 88 L.Ed. 333 (1944). Moreover, "courts are without authority to set aside any rate selected by the Commission which is within a 'zone of reasonableness'." *In re Permian Basin Area Rate Cases*, 390 U.S. 747, 767, 88 S.Ct. 1344, 1360, 20 L.Ed.2d 312 (1968) (quoting *FPC* v. *Natural Gas Pipeline Co.*, 315 U.S. 575, 585, 62 S.Ct. 736, 743, 86 L.Ed. 1037 (1942).

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[4] After Opinion No. 16, the following capitalization and returns applied to RP74-20/83:

	Amount (000's)	Ratio	Cost	Weighted Cost
Long-Term Debt	$224,681	54.96%	8.9 %	4.891%
Preferred Stock	100,000	24.46%	–0–	–0–
Common Equity	84,129	20.58%	14.00%	2.881%
	$408,810	100.00%		7.772%

Nevertheless, we are not without guidelines to determine whether the Commission has acted within its authority and we will not hesitate to set aside the Commission's order when its total effect is not fair and reasonable. The Supreme Court first set out these guidelines in 1944 in *Hope Natural Gas Co.:*

> The rate-making process under the Act, i.e., the fixing of "just and reasonable" rates, involves a balancing of the investor and the consumer interests. Thus we stated in the Natural Gas Pipeline Co. case that "regulation does not insure that the business shall produce net revenues." But such considerations aside, the investor interest has a legitimate concern with the financial integrity of the company whose rates are being regulated. From the investor or company point of view it is important that there be enough revenue not only for operating expenses but also for the capital costs of the business. These include service on the debt and dividends on the stock. By that standard the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital.

320 U.S. at 603, 64 S.Ct. at 288 (citations omitted). We need only examine whether the Commission's rates are designed to generate sufficient revenue to cover the capital costs of the business. Coverage of United's operation expenses is not at issue here.

[3] The Commission set overall rates of return on capital of 7.77% and 7.59% in Docket Nos. RP74-20/83 and RP75-30, respectively. United urges that these overall rates fall

below those available on comparable investments and below the level necessary to attract capital. The overall rate, however, is merely the weighted average of the separate rates allowed by the Commission on the various types of capital on the utility's balance sheet.[5] The overall rate of return is the conclusion, not the premise. The overall rate of return is reasonable if the rate of return on each of its elements is reasonable. If the return set on each element is fair and reasonable, computing the overall rate of return by finding the weighted average is simply an arithmetical procedure to ensure that the revenues generated provide the proper rate of return on each component.[6] We must therefore determine whether the Commission allowed a fair and reasonable return on each portion of United's capital.

A. *Classification of Capital*

[4] The first step in making such a determination is the classification of capital. As we noted in *El Paso Natural Gas Co.* v. *FPC*, 449 F.2d 1245, 1251 (5th Cir. 1971):

> The procedure . . . of separately determining the portions of a company's capital structure related to debt, to preferred stock, and to common equity, and separately assessing a fair and reasonable return

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[5] The overall rate of return on capital is computed by multiplying the rate on each class of capital by the ratio of that class to the total capital and adding the products. For example, if Firm X's capital stock comprises $200 million debt and $100 million equity, the overall rate is two-thirds the return on debt plus one-third the return on equity. If those rates are 6% and 9%, respectively, the overall rate of return is $(\frac{2}{3}\times 6\%)+(\frac{1}{3}\times 9\%)=4\%+3\%=7\%$. *See* nn. 2-4 *supra*.

[6] To use the example in note 5 *supra*, allowing a 7% return on the total $300 million of capital would provide $21 million in revenue, $12 million to pay 6% interest on $200 million debt and $9 million available for distribution to the equity holders.

based upon differing allowances to each of these segments, is the common and accepted practice for this phase of ratemaking. Under such a procedure the Commission must perforce determine the appropriate amounts to be included in each category.

United's capital is difficult to classify because of the spin-off settlement, which rescinded the issuance of the $100 million preferred stock and required the refund of the $15 million equity contribution to Pennzoil and the return of the preferred stock dividends to United. During the locked-in period, United's capital structure comprised $100 million in preferred stock, $92 million in common equity, and $212 million of long-term debt. After the settlement went into effect, the $100 million was restored to United's common equity accounts,[7] eliminating the preferred equity on United's balance sheet. The question for the Commission was whether for ratemaking purposes United's balance sheet during the locked-in period should be treated as it actually existed during that period or instead as it was refashioned by the spin-off settlement.

In Opinion No. 16, the Commission chose the former course and classified the $100 million as preferred capital

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[7] With the refund of the $15 million, the net increase in common capital was $85 million, which was credited to United's retained earnings account. The preferred stock was not converted to treasury stock; no new shares were authorized; no new liability offset this increase in assets. Thus, the common equity shareholders enjoyed an increase in the book value of their investment of $85 million or 91%. United's reply brief, in arguing that the equity contribution and dividends were offsetting, states that the returned dividends were credited to its capital accounts. If that is the case, the net increase was approximately $100 million or 108%.

during the locked-in period.[8] It reasoned that classification of capital is a means toward determining the risk associated with that capital. During the locked-in period, the holder of the preferred stock in fact enjoyed a senior claim on United's earnings. The preferred investment was less risky than that of the common equity holders, who were bound to recognize that prior claim. The capital was properly classified to reflect that fact. The Commission concluded:

> We find no error in the conclusion of the Presiding Judge that this $100 million of United's outstanding capital is properly classified and costed as preferred capital. The classification found appropriate by the Presiding Judge accords with the realities existent during the locked-in period involved in the instant proceeding, and it is adopted.

United asserts that to characterize the $100 million as preferred equity ignores the terms of the spin-off settlement, which provided that the preferred stock and equity contribution were to be "rescinded and restored as of [their dates of issue]." The word "rescind" was carefully chosen, United argues, for its precise legal meaning, that of restoring the funds as if the spin-off had never taken place.

We agree that "rescind" has a precise legal meaning and was chosen by the parties for a specific purpose. That purpose, however, was to undo any possible violation of section 12 of the Natural Gas Act that Pennzoil might have

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[8] All parties agree that the long-term debt and the remaining equity were properly classified. Only the $100 million is in dispute.

committed by the spin-off.[9] The mere use of the word "rescind," however, did not require the Commission, in setting rates, to blink the reality that the spin-off occurred and existed during the locked-in period.

The Commission properly classified the $100 million as preferred stock during the locked-in period to accord with then-existing realities. It also properly held that the common equity included Pennzoil's $15 million contribution even though it was subsequently "rescinded" and returned, because that contribution was a part of United's common equity during the locked-in period.

The Commission stated that it classified the $100 million of preferred stock to determine the risk associated with that capital. Of equal importance, however, the classification of preferred capital determines the risk associated with the $93 million of common equity. Earnings otherwise available for distribution to common stockholders are subject to the senior claims of bondholders and preferred stockholders.

United does not quibble with the conclusion that the risk must be assessed in light of the perceptions of the investors during the locked-in period. It asserts, however, that there is no evidence of what the investors actually perceived during the locked-in period. Investors may well have been aware from an early stage, United contends, that the settlement negotiations would lead to the return of the $100 million to United's common equity accounts. If they were thus

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[9] The portion of section 12 relevant to the spin-off states in pertinent part: "[I]t is unlawful for any officer or director of any natural-gas company . . . to participate in the making or paying of any dividends, other than liquidating dividends, of such natural-gas company from any funds properly included in capital account." 15 U.S.C. § 717k.

aware, the argument runs, they did not expect the preferred stock to enjoy a senior claim on earnings.[10]

The evidence introduced by United in support of this proposition consisted of an account in the *Wall Street Journal* of the settlement negotiations. To draw conclusions about investors' thought processes from this news release would be rank speculation. In basing its findings upon "the existence of the preferred stock, and upon common business perceptions regarding the relationship between preferred and common stock," the Commission acted correctly. Indeed, in the absence of evidence indicating that United's common shareholders ignored conventional investment realities, we might have been compelled to set aside a Commission decision to use a hypothetical balance sheet to determine United's rates.[11] We affirm the Commission's decision to use the capital structure as it actually existed during the locked-in period and to classify the $100 million as preferred equity.

B. *Cost of Each Class of Capital*

[5] Each class of capital should be costed separately. *Hope Natural Gas* requires that the allowed rate generate

[10] This argument is undercut by United's assertion, elsewhere in its brief, that no rational investor would have expected that the Commission would require United to return the $15 million equity contribution without receiving the refund of its preferred stock dividends, *i.e.*, these hypothetical investors would have expected United to have to pay $15 million to get back its approximately $15 million in dividends. If these hypothetical investors believed as United urges, they would then have perceived a senior claim on United's earnings – either to pay the dividends or to refund the supposed offset. If they did, the risk they expected to undertake was no less than that of an investor who knew nothing about the settlement.

[11] We do not address the Commission's contention that in appropriate cases it may use a hypothetical capital structure to determine rates.

sufficient revenue for the capital costs of the business. The rate of return on each class must therefore be sufficient for the utility to recover its cost on that class. The proper procedure for "costing" capital depends on the kind of capital involved.

[6] 1. *Common Equity.* The Supreme Court has set out guidelines for the proper costing of equity capital:

> [T]he return to the equity owner should be commensurate with returns on other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital.

FPC v. *Hope Natural Gas Co.*, 320 U.S. at 603, 64 S.Ct. at 288. It is true that these guidelines — called the "comparable earnings" standard and the "capital attractiveness" standard — are neither exhaustive nor exclusive. Indeed, the Commission may set fair and reasonable rates without reference to these standards. *See El Paso Natural Gas* v. *FPC*, 449 F.2d 1245, 1251 — 52 (5th Cir. 1971). But if both these standards are satisfied, it is unlikely that the resulting rate would not be fair and reasonable.

[7] The first step in determining the cost of common capital is to weigh the riskiness of the investment. In making this assessment, the Commission correctly viewed the situation as it appeared to an investor during the time he held his investment. The evaluation of risk, after all, entails the prediction of future outcomes then unknown. As the Commission noted, the spin-off settlement's effectiveness "did not and could not affect investment decisions during the effective period of the instant rates."

The Commission correctly looked to United's financial structure. United's shareholders could not expect Pennzoil

to satisfy their investment expectations; United's common equity had to be evaluated on the strength of United alone. The common equity holders knew that United would have to pay interest to the bondholders and a stated dividend to the preferred shareholders before any of the earnings would be available for distribution to them. United's "thin" equity ratio[12] meant that common equity investment in United was riskier than in other firms whose earnings were used for comparative purposes.[13]

The Commission then weighed business factors. United had a difficult supply outlook. Adverse economic conditions prevailed during the locked-in period. The spin-off arrangements themselves made the risk appear greater because United's shareholders could no longer look to Pennzoil. The fact that the Commission was investigating the spin-off heightened the risk perceived by investors during the locked-in period. The Commission properly recognized that all these factors argued for a higher return than would be realized on alternative investment earnings. The evidence of alternative investments against which United had to

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[12] United's common equity ratio was only 22.92% during the period covered by RP75-30; only $92,910,000 of United's total capitalization of $405,397,000 was common equity. In RP74-20/83, $84,129,000 of $224,681,000, or 20.58%, was common equity. These figures include Pennzoil's $15 million capital contribution even though subsequently refunded, for it was in fact reflected on United's balance sheet during this locked-in period and investors consequently expected to earn a return on this portion of their equity as well. Moreover, the common equity ratios included the $15 million; without it, they would have been still lower.

[13] When a corporation's capital is highly leveraged, as United's is here – that is, the ratio of debt and preferred obligation to common equity is high – the return on common equity becomes increasingly volatile, as small percentage changes in revenues becomes large percentage changes in earnings available for distribution to common shareholders.

compete tended to show a reasonable and fair range of equity earnings from 14.00% to something in excess of 15.00%. The Commission concluded that, based on a common equity ratio of 22.92% and all the above factors, a rate of return on common equity of 15.00% was justified.[14]

Viewing the circumstances as they actually existed during the locked-in period, with an awareness that a reasonable rate of return is characterized by an area, not a point, *see Montana-Dakota Utilities Co.* v. *Northwestern Public Service Co.*, 341 U.S. 246, 251, 71 S.Ct. 692, 695, 95 L.Ed. 912 (1951), the return allowed to the investors in common equity is fair and reasonable.

2. *Preferred Stock.* Costing preferred stock, like debt, is usually a straightforward matter. Preferred stock bears a stated dividend, an amount that the company is obliged to declare to holders of the preferred issue before it makes any distribution to the common stockholders. When the stock is "cumulative," as it is here, if the company should ever fail to pay the stated dividend, common shareholders may receive no dividend until all missed dividends on the preferred stock are made up. The cost to the utility, then, is the "embedded" or actual historical cost, which is ordi-

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[14] In RP74-20/83, the Commission allowed a return of 14.00% on common equity. This figure had been arrived at by settlement in December 1975 and approved by the Commission in Opinion No. 815. In Opinion No. 815-A, the Commission reopened the settlement to consider the effect of the Spin-off Settlement. After due consideration, the Commission maintained the settlement return of 14.00% on common equity, reasoning, as it did in RP75-30, that the Spin-off Settlement could not have affected investors' perceptions of risk during the locked-in period. That the allowed rate is 14.00% rather than 15.00% is of no consequence: the common equity ratio was different from that in the subsequent proceeding; business conditions may have been different; and the rate was agreed upon by settlement.

narily the stated dividend. As one noted authority has observed:

> The determination of the cost of preferred stock is carried out in much the same manner as for debt. Commissions look upon the percentage dividend as being almost as much a contractual obligation as interest on bonds. The actual historical cost of preferred stock is computed by taking the fixed dividend rate and adjusting for costs of flotation and any other unamortized expenses.[15]

It is not necessary to engage in the rough and approximate techniques used for common equity of examining alternative investments and subjectively assessing the riskiness of the enterprise.

The normal costing procedure must be adapted to the peculiar circumstances of this case. The Commission applied a technique it had used in other unusual rate proceedings:

> When computing the embedded costs of debt and preferred stock it is appropriate that the cost allowed is net of gains and losses or expenses that are associated with the particular securities.

For these rate proceedings, the net cost of the preferred stock to United was zero because Pennzoil returned all dividends to United.

United's principal objection to costing the preferred stock at zero[16] is that the Commission thereby "erroneously re-

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[15] P. Garfield & W. Lovejoy, *Public Utility Economics* 124 (1964).

[16] United's first argument was that the $100 million should have been classified as common equity. We have already explained why that contention is untenable. United makes these additional objections assuming that we affirm the Commission's classification.

fashions the Spin-Off Settlement." This argument runs as follows: The Commission construed the return of dividends out of context, ignoring the remaining terms of the agreement. United received no windfall because the return of the dividends was almost exactly offset by United's return to Pennzoil of the original contribution to United's equity. The net effect of those two payments was "a virtual wash," so the $100 million did indeed have a net cost to United during the locked-in period.

This argument is unpersuasive. As the Commission noted, there were several transactions involved in the spin-off. The equity contribution was an integral part of the consideration for making the entire spin-off, just as its refund was part of the consideration for its undoing. The return of the equity contribution was as much a part of the *quid pro quo* for the return of the preferred stock as it was for the return of the dividends.

Moreover, it was merely fortuitous that the dividends and the equity contribution were nearly equivalent in amount. The spin-off settlement did not specify the amount of the dividends to be returned to United, because the drafters were uncertain when the settlement would become final. United, however, was to continue paying dividends until it did become final, and it was the clear intention of the settlement that *all* preferred dividends paid be returned to United. Had the settlement become final but three days later — on January 1 instead of December 28 — the amount of dividends to be returned would have increased to $17,577,083, and United's argument would become untenable.

United's second argument against assigning a zero cost to the preferred stock is that it denies United the oppor-

tunity to earn any return on $100 million of its capital;[17] *i. e.*, it is not fair and reasonable to allow zero return on the $100 million, regardless of the effect of the spin-off settlement. The $100 million represents claims against assets that are dedicated to public service, United contends, investments on which it is entitled to earn a return. United urges that the mere ownership of assets entitles it to receive a return on those assets; even though the allowed return may vary, it cannot fairly be zero if those assets were engaged in a productive capacity during the period in which a return is sought.

This argument too is unavailing. A corporation does not earn money for its "own" benefit, but to repay its creditors and then for the benefit of its owners, the shareholders. Those who held United's common equity during the locked-in period have been justly compensated by United's earnings during that prior by the Commission's allowances of 14% and 15% return on common equity. The one who will earn no return on the investment of $100 million is the sole holder of that preferred equity, Pennzoil. That result, however, does not flow from any of the rate proceedings; rather, it is the result of the spin-off settlement. If it is a harsh result for Pennzoil to have been deprived of any

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[17] Besides the arguments we address here, United urges in support of this contention two propositions that we have already decided adversely to it. First, it argues that because the preferred stock derived from its common equity accounts, the $100 million should have been treated as common equity. We have approved the Commission's classification of $100 million as preferred to accord with reality. Second, it contends that the overall rates of return that result from costing the preferred at zero – 7.77% for RP74-20/83 and 7.59% for RP75-30 – are not fair and reasonable because they are lower than those available in equally risky enterprises and too low to attract capital. The overall rate of return is only a weighted average. It is fair and reasonable if, and only if, the rate of return for each of its components is fair and reasonable. *See* n.5 *supra*.

return on $100 million during the locked-in period, it is a result Pennzoil contracted for in the spin-off settlement and one of which it does not now complain.

For a regulated utility such as United, productive assets do not churn out a product at a rate of return set by an unseen hand. In an unregulated industry in a free-market economy, Adam Smith's "invisible hand" may set such a rate, one that takes no revealed knowledge to discern. The market sets the price of the firm's output, and the rate of return to its owners is dictated by its productive processes and the market mechanism. But government regulates certain industries precisely because it does not want market forces to set those rates, usually because the industry is monopolistic or oligopolistic. Instead, an agency sets those rates to balance the interest of consumers and investors. The kilowatt-hours, or message-units, or thousand cubic feet produced by a utility have no intrinsic dollar value in a regulated industry.

[8, 9] We need not decide here what disposition of this case would be appropriate had Pennzoil retained the common stock as well as the preferred stock. The United common stock holders had no expectancy of return on the $100 million represented by the preferred stock. This $100 million worth of assets reflected in the preferred stock was removed from the assets reflected in the book value of the common stock. Pennzoil having itself given up that return, the cost-free use of the $100 million worth of assets was an unexpected benefit unassociated with risk or expectancy of benefit. Therefore, when a utility enjoys an unexpected benefit that is not associated with the risk sought to be undertaken by the investors, the regulating authority may properly determine that such benefit should accrue to the consumers rather than to the investors. For example, if a munificent investor were to put up all the capital for a utility free of charge, the Commission could properly set

the rates to reflect costs of production only. In the case before us, it was within the informed discretion of the Commission, recognizing that the cost of $100 million in capital had been borne by Pennzoil and not by United, to order that the rates be set so that the consumers gain the benefit of United's low-cost capital, rather than letting United charge as much as would have been appropriate had that capital been acquired by United in the market and paid for at the market's rate.

United also contends that the fair rate of return on capital — including preferred capital — is not determined by the amount the company pays in dividends on that capital. United analogizes to common equity: "No one disputes that a regulated company's dividend policy on its common stock should not affect the rate of return allowed on that portion of its capitalization." Such an analogy is inapposite. Common and preferred stock are very different investments, costed according to different principles.

The rate of return allowed on common equity must be sufficient to reward the investors' risk and to attract capital. The reward on common cannot be equated solely to the dividend the investors receive, for companies frequently elect not to distribute all or even any of their earnings. Instead they may choose, for example, to retain them in order to further business needs or to finance new asset acquisition. In so doing, however, the book value per share of common stock increases, and, in any normal market, the price of the common stock should increase. Thus, an investor in common equity normally expects to derive his reward from both dividends and capital appreciation.

[10] Preferred stockholders, in contrast, receive their reward almost exclusively from the stated dividend.[18] Thus

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[18] While the market price of a share of preferred stock does fluctuate, the price responds primarily to changes in the prevailing

the argument that a company's dividend policy on common stock may not affect the rate of return allowed thereon is not persuasive with respect to preferred equity. On the facts of this case, it was appropriate to cost the preferred stock by means of its net embedded cost to United. We therefore reject United's argument that it is entitled to some rate of return for its $100 million of preferred stock, regardless of its cost to United.

It was suggested at oral argument, however, that it was fatally inconsistent for the Commission to classify the $100 million as preferred and the $15 million capital contribution as common "to accord with the realities of the locked-in period," while at the same time looking to post-period transactions, namely the return of the dividends, to determine the cost to United of that $100 million. We find nothing in the Commission's treatment that is not fully warranted by the differences between common and preferred equity and the need to determine their rates of return differently.

Because the return on common equity is designed to compensate the investor for the risk he perceives to undertake, it must be determined by looking at the situation as it appeared to a typical investor, viewing the situation prospectively as it in fact existed. Therefore, capital must be classified as it then appeared on the balance sheet. The cost

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interest rate, much like the price of a bond. Continued retention of earnings could make the company appear more sound financially. However, increasing the retained earnings does not usually increase the book value of preferred stock, as it does for common stock, because preferred shareholders typically have a priority claim against a fixed amount of assets. If the company had a poor financial history, such a bolster could enhance the market price of a share of preferred. In the case of a solvent company such as United, this effect is de minimis, however, compared to the interest rate effect.

of common equity is determined in part by reference to that classification.

Preferred stock does not require such an exclusively prospective look, however, because it is costed on a payout basis, not on a risk-rewarding basis. Here, that rate was set first at 9.75% by Pennzoil's holding it at the stated dividend and subsequently at zero by the agreement reached in the spin-off settlement.

The question then becomes, what is the appropriate measure of the embedded cost of preferred when, as here, events at the end of a period affect the actual cost paid by the utility? To compute the embedded cost of debt or preferred stock, the Commission has adopted the practice of allowing the cost net of gains and losses or expenses realized in connection with the security. For example, savings realized when a utility repurchases its debt are held to reduce the embedded cost of that debt to the utility, and the allowed rate of return thereon is reduced accordingly. That treatment reflects a Commission determination that "all savings arising from the repurchase of debt at a discount should be passed on to the consumer." *Kansas-Nebraska Natural Gas Co.*, 53 F.P.C. 1691, 1708-09 (1975). *See also Manufacturers Light and Heat Co.*, 44 F.P.C. 314 (1970).

The purpose of computing the embedded cost of preferred equity is to determine its actual historical cost. Thus, computing the embedded cost as the Commission has done here is an appropriate method. To ignore gains and losses realized thereon simply because they were not foreseeable at the beginning of the period would avoid reality for no good reason. It cannot be gainsaid that this method is the most accurate way of calculating the capital's cost to the utility. Moreover, the Commission has amply demonstrated, as we have described above, that it does not produce unfair or unjust results. The difference in treatment of common

and preferred stock does not demonstrate an inconsistency. Rather, it is the result of consistent application of sound ratemaking principles.

III

It is unusual for the Commission to allow zero return on $100 million of a utility's capital. However, the spin-off settlement created an extraordinary situation. For reasons it deemed proper, Pennzoil, the preferred shareholder, agreed to return all dividends paid on its $100 million of preferred stock during a twenty-one month period. Capital is never cost-free in the absolute, but in this case it was cost-free to United, for Pennzoil bore its entire cost. The rates set by the Commission properly reflected this unusual circumstance. United will earn sufficient revenues, after operating expenses, to pay the interest on its debt and offer a suitable reward to its common equity holders. The Commission properly discharged its responsibility in allocating this singular benefit to the ratepayers.

AFFIRMED.

Appendix B

IN THE UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

No. 79-1903

UNITED GAS PIPE LINE COMPANY,
Petitioner,

versus

FEDERAL ENERGY REGULATORY COMMISSION,
Respondent.

PETITION FOR REVIEW OF AN ORDER OF THE FEDERAL ENERGY REGULATORY COMMISSION

ON PETITION FOR REHEARING
(July 30, 1980)

Before CHARLES CLARK, RONEY and GARZA, Circuit Judges.

PER CURIAM:

IT IS ORDERED that the petition for rehearing filed in the above entitled and numbered cause be and the same is hereby denied.

ENTERED FOR THE COURT:

CHARLES CLARK
United States Circuit Judge

Appendix C

UNITED STATES OF AMERICA
FEDERAL ENERGY REGULATORY COMMISSION

OPINION NO. 16

UNITED GAS PIPE LINE COMPANY	DOCKET NOS. RP75-30, RP74-20, RP74-83

OPINION AND ORDER AFFIRMING IN PART INITIAL DECISION

Issued: July 3, 1978

UNITED STATES OF AMERICA

FEDERAL ENERGY REGULATORY COMMISSION

UNITED GAS PIPE LINE COMPANY	DOCKET NOS. RP75-30, RP74-20, RP74-83

OPINION No. 16

APPEARANCES

Stephen A. Wakefield and *I. Jay Golub* for United Gas Pipe Line Company.

William W. Bedwell and *James H. Wuller* for Mississippi River Transmission Corporation.

Harry L. Albrecht for Natural Gas Pipeline Company of America.

J. David Mann, Jr. and *A. Karen Hill* for Laclede Gas Company.

William T. Miller and *Stanley W. Balis* for United Municipal Distributors Group.

Karen E. Hakel for Northern Natural Gas Company.

George E. Morrow, Reuben Goldberg and *Arnold Fieldman* for Memphis Light, Gas and Water Division.

Carl W. Ulrich, William R. Duff, James R. Lacey and *Edward S. Kirb* for Public Service Electric and Gas Company.

Donald S. Quinn for Texas Eastern Transmission Corporation.

Peter H. Schiff and *Richard A. Solomon* for Public Service Commission of the State of New York.

Dennis Lane for the Staff of the Federal Energy Regulatory Commission.

CAPITALIZATION
RATE OF RETURN

UNITED STATES OF AMERICA
FEDERAL ENERGY REGULATORY COMMISSION

Before Commissioners:
CHARLES B. CURTIS, *Chairman;*
GEORGIANA SHELDON, MATTHEW HOLDEN, JR.,
AND GEORGE R. HALL.

UNITED GAS PIPE LINE COMPANY	DOCKET NOS. RP75-30, RP74-20, RP74-83

OPINION NO. 16

OPINION AND ORDER AFFIRMING IN PART INITIAL DECISION

(Issued July 3, 1978)

On October 1, 1977, pursuant to the provisions of the Department of Energy Organization Act (DOE Act), P.L. No. 95-91, 91 Stat. 565 (August 4, 1977), and Executive Order No. 12009, 42 *Fed. Reg.* 46267 (September 15, 1977), the Federal Power Commission (FPC) ceased to exist and its functions and regulatory responsibilities were transferred to the Secretary of Energy and the Federal Energy Regulatory Commission (FERC), which, as an independent commission within the Department of Energy, was activated on October 1, 1977.

The "savings provisions" of Section 705(b) of the DOE Act provide that proceedings pending before the FPC on the date the DOE Act takes effect shall not be affected, and that orders shall be issued in such proceedings as if the DOE Act had not been enacted. All such proceedings shall be continued and further actions shall be taken by the

appropriate component of DOE that has become responsible for the function according to the DOE Act and regulations promulgated thereunder. The statutory function with which this proceeding is concerned was specifically transferred to FERC by Section 402(a)(1) of the DOE Act.

Moreover, the joint regulation adopted on October 1, 1977, by the Secretary of Energy and FERC, entitled "Transfer of Proceedings to the Secretary of Energy and the FERC," 10 C.F.R. § . . . , provided that this proceeding would be continued before FERC. We, therefore, take the following action in this proceeding in accordance with the above mentioned authorities. The term "Commission," when used in the body of this Opinion, shall refer to the Federal Power Commission with respect to actions taken before October 1, 1977, and shall refer to the FERC with respect to actions taken at any time subsequent to October 1, 1977.

On November 4, 1974, United Gas Pipe Line Company (United) filed a proposed rate increase of $102,366,409 for jurisdictional service. This rate increase was, in part, predicated upon a capitalization reflecting $100 million of preferred stock at a cost of 9.75% per annum.[1] This filing was accepted by the Commission in Docket No. RP75-30, and, by order issued December 19, 1974, the proposed increase was suspended until May 20, 1975. Thereafter, the increased rates became effective, subject to refunds. On May 30, 1975, United filed a superseding rate increase for its jurisdictional service, which, by order issued July 7, 1975, in Docket No. RP75-109, was accepted by the Commission, suspended, and ultimately became effective, subject

[1] United's total capitalization consists of $212,487,000 in debt at a non-contested cost of 7.92%; $92,910,000 of common equity at a cost claimed by United of 15.00%-17.00% and, the $100 million of preferred equity at a nominal cost of 9.75%.

to refund, on December 15, 1975. Thus, in the present case, we consider the reasonableness of those rates charged by United during the locked-in period from May 20, 1975 through December 15, 1975.

Through settlement negotiations and agreement the majority of the contested issues in this case were resolved.[2] The sole remaining issue to be decided by the Commission relates to the fair and reasonable rate of return to be allowed. The primary concern of the parties opposing the rate of return claimed by United in its rate filing is the company's reliance upon a capital structure and assigned costs of capital which include a preferred stock issuance which was subsequently rescinded in a separate proceeding before the Commission.[3] In the instant case the Commission is, for the first time,[4] directly confronted with the

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[2] The settlement involving the remaining issues in this case was certified to the Commission under separate cover by the Presiding Judge, *ID*, pg. 2, and will be addressed by separate order of the Commission.

[3] *See, Investigation of Pennzoil Company-United Gas Pipe Line Company Spin-off and Related Transactions*, Docket No. RP74-67, 54 FPC 2511 (November 28, 1975). *(Spin-off Settlement Order)*. The cancellation of the preferred stock issue took place on December 30, 1975, subsequent to the end of the instant locked-in period. The spin-off arrangement was in effect, however, during the entire period that the rates in this docket were collected by United, subject to refund. It was also in effect during the entire effective period of United's rates filed in Docket Nos. RP74-20 and RP74-83. *See*, n. 4, *infra*.

[4] In Docket Nos. RP74-20 and RP74-83, Laclede Gas Company tendered a motion requesting that the record be reopened for consideration of the impact of the United-Pennzoil spin-off upon the 10.157% rate of return arrived at in those consolidated proceedings. In Opinion No. 815-A, issued on November 15, 1977, Laclede's allegations were severed from that case, and consolidated within the instant proceeding for decision. In doing so,

ratemaking ramifications of the Spin-off Settlement, as approved by the Commission.

THE PENNZOIL-UNITED SPIN-OFF ARRANGEMENT

Prior to March 14, 1974, United was a wholly-owned subsidiary of the Pennzoil Company (Pennzoil), which meant, of course, that the corporate entity, Pennzoil, held 100% of its subsidiary's common equity capital. On March 13, 1974, United declared a dividend to its then-parent of $100 million in preferred stock bearing a dividend rate of 9.75% per annum.[5] The following day Pennzoil declared a dividend

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the Commission effectively treated Laclede's allegations as a complaint that the stipulated return of 10.15% was excessive for the reason that United and the other parties to the settlement improperly costed United's outstanding preferred stock at 9.75% per annum.

Because we find here that United was not entitled during the effective period of the original spin-off transaction to receive any return on that capital then-classified as preferred stock, it follows that appropriate adjustment to the return allowance must be considered in Docket Nos. RP74-20 and RP74-83 as provided for in Opinion No. 815-A. Elimination of the cost attributable to the preferred stock would yield, under the stipulated overall return of 10.157%, an excessive return on common equity of 25.59% (Per Exhibit E of Docket No. RP74-20, *et al.*). Accordingly, the stipulated overall rate of return is excessive and unreasonable. We calculate that while maintaining the settlement return on common equity of 14%, the overall rate of return should be reduced to 7.77 percent to reflect the costing of the preferred stock at zero. We find that United should make appropriate refunds of the excess amounts charged in those dockets in accordance with our determination here.

[5] In total, the aggregate amount of preferred stock dividends paid by United to Pennzoil during the effective period of the original spin-off transaction totalled approximately $15 million.

of all its common equity stock in United to its (Pennzoil's) stockholders, thereby divesting itself of its ownership of the subsidiary.[6] Also, as part of the spin-off arrangement, Pennzoil effectively made a $15 million capital contribution to United.[6]

The Commission immediately instituted an investigation of the spin-off transaction to determine whether it was consistent with the public interest and whether any violations of the Natural Gas Act had been committed. This investigation led to settlement negotiations and, ultimately, to the proffer of a settlement agreement. Hearings were held on this proffered agreement, and the Chief Administrative Law Judge issued an initial decision recommending its approval by the Commission. By order issued November 28, 1975,[7] the Commission approved the proffered Spin-off Settlement. In relevant part, the Spin-off Settlement Order required the cancellation of the preferred stock issued to Pennzoil by United and the return of all previously paid preferred stock dividends. The Spin-off Settlement Order also required United to return the capital contribution of $15 million made by Pennzoil.

In the instant case the Commission is not concerned with any reassessment of the Spin-off Settlement's terms or its impact upon United or Pennzoil. Our sole concern in the

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[6] As a coincidence, the implementation of the Spin-off Settlement Agreement resulted in United's return of $15 million in capital contributions at the same time that Pennzoil returned approximately $15 million in previously paid preferred stock dividends. The reasons for these respective payments, however, bear no relationship whatsoever to the fortuitously equivalent amounts transferred. United seeks to ascribe a particular significance to the equivalent amounts of exchanged monies between the companies under the Spin-off Settlement, but this putative significance is not readily apparent to the Commission.

[7] *See*, n. 3, *supra*.

present case is the reasonableness of the rates charged by United during the effective period of the original spin-off arrangement. The threshold question is whether the Spin-off Settlement Order of the Commission has any impact upon the revenues collected by the regulated company, United, from its customers — *i.e.*, whether any refunds to customers are due as a consequence of the Spin-off Settlement.

THE INITIAL DECISION

After settlement of the majority of contested issues in this case, hearings herein were limited to the issues of United's proper capitalization and rate of return for the locked-in period. Hearings on these reserved issues were held in December 1976, and, after a reassignment of the Presiding Administrative Law Judge, the initial decision was issued in this matter on October 14, 1977,[8] by Presiding Administrative Law Judge Allen C. Lande. Exceptions to the Judge's decision were filed on November 14, 1977, by United, the United Municipal Distributors Group (MDG), and the Public Service Commission of the State of New York (New York).[9] Briefs opposing filed exceptions were filed on December 5, 1977, by each of the parties filing exceptions as well as Laclede Gas Company (Laclede), Memphis Light, Gas & Water Division (Memphis), and Commission staff.[10]

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[8] "Initial Decision on Proper Capitalization and Rate of Return," *United Gas Pipe Line Company*, Docket No. RP75-30, October 14, 1977. (*ID*)

[9] "Brief on Exceptions of United Gas Pipe Line Company," filed November 14, 1977. (United's Br.) "Brief on Exceptions of the Public Service Commission of the State of New York," filed November 14, 1977. (New York's Br.) "Memorandum Brief on Exceptions of United Municipal Distributors Group," filed November 14, 1977. (MDG's Br.)

[10] "Brief of United Gas Pipe Line Company Opposing Exceptions," filed December 5, 1977. (United's Br. Opp.) "Reply Brief on

Addressing the question of the appropriate capital structure to be employed in the instant case, the Presiding Judge held that the subsequent rescission of the preferred stock issue by the Spin-off Settlement should *not* affect the classification of United's actual outstanding capital during the instant locked-in period. During this period $100 million of United's capital was classified as preferred stock by the company, bearing a nominal cost to United of 9.75% per annum. The Judge held that the subsequent cancellation of the preferred stock and the return of all previously paid dividends by Pennzoil "does not mean that the preferred stock is to be considered never to have existed as far as United's relationships with its ratepayers (or other parties) is concerned." *ID,* pg. 4. Accordingly, for classification purposes, the Presiding Judge reflected the $100 million as preferred stock in United's capital structure for the locked-in period.

This classification finding by the Judge is heavily influenced by the Presiding Judge's interpretation of the Commission's Spin-off Settlement Order. The Judge found that the Commission's investigation was concerned solely with the post-spin-off, inter-corporate relationship between Pennzoil and United and the readjustment of the terms of the original spin-off arrangement. Upon this construction of the Commission's intent and purpose, the Presiding Judge concluded that the adjustment of obligations occas-

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Exceptions of the Public Service Commission of the State of New York," filed December 5, 1977. (New York's Br. Opp.) "Brief Opposing Exceptions of United Municipal Distributors Group," filed December 5, 1977. (MDG's Br. Opp.) "Staff's Brief Opposing Exceptions," filed December 5, 1977. (Staff's Br. Opp.) "Brief of Memphis Light, Gas & Water Division Opposing Exceptions of United Gas Pipe Line Company," filed November 28, 1977. (Memphis Br. Opp.) "Brief Opposing Exceptions of Laclede Gas Company," filed December 5, 1977. (Laclede's Br. Opp.)

ioned by the Spin-off Settlement were not intended to operate as a "determination of proper rates for United's customers or rate treatment of the preferred equity for that [locked-in] period." *ID*, pg. 5. The Judge found the pertinent and controlling principle applicable to this rate proceeding to be that, for any period, "a utility's rates are to be based on its costs and a fair return." *ID*, pg. 5. Thus, the question became the appropriate *cost* to be assigned for maintaining United's $100 million of "preferred equity" during the locked-in period.

Through its effective rates United had collected a cost of 9.75% on this $100 million of its capital which the Presiding Judge found to be properly classified as preferred equity during the locked-in period. During the locked-in period, United periodically paid dividends at this 9.75% per annum rate to Pennzoil. By virtue of the Spin-off Settlement, however, Pennzoil returned all previously paid dividends. This resulted, according to the Presiding Judge, in a double recovery of the 9.75% cost to United for maintaining this $100 million of its investor-supplied capital during the locked-in period — once from the ratepayers and once from Pennzoil. Presumably, the Presiding Judge found it necessary to reflect United's outstanding preferred stock in the company's capitalization at a zero cost rate in order to affect refunds *of one-half of this so-called double recovery* to United's ratepayers, and he so ordered.

> Assignment of zero percent cost to this $100 million for the locked-in period would be an equitable and appropriate way to give recognition to these circumstances. It would prevent United from recovering the cost of the stock dividends a second time, and would result in refunding to the ratepayers the amount by which they reimbursed United for costs later returned to it by Pennzoil. (*ID*, pg. 6).

Implicit in the findings of the Presiding Judge is his belief that United is entitled to recover the cost of maintaining this portion of the company's investor capital for the locked-in period, such cost presumably being the nominally assigned cost of 9.75% per annum. The refunds ordered for the ratepayers stem from the conclusion that United had recovered this cost of 9.75% per annum from two separate sources, the ratepayers and, separately, from Pennzoil. The Presiding Judge apparently believed that this result would leave United whole and simply prevent a second recovery of a legitimate capital cost.

Finally, the Presiding Judge considered the appropriate return on common equity which was supported by the record before him. United has claimed a cost of its outstanding equity — a classification within which the company includes the $100 million of investor capital which was classified as preferred stock during the locked-in period—of 15%. Commission staff also recommended a return allowance of 15.00% but only upon the $93 million of outstanding equity stock. In a discussion of those factors influencing his decision on this issue, the Presiding Judge held that "a rate of 15% on equity represents a rate of return for this [locked-in] period sufficient to allow United to continue to attract capital and to maintain its financial integrity." *ID*, pg. 7. It should be noted that the Presiding Judge did not grant a return allowance comparable to 15% upon the combined preferred and equity investment, as United had claimed. Rather, the allowance approved was 15% on the approximately $93 million of capital which was found to be legitimately classified as common equity during the period, for the Presiding Judge also found that United's capital structure must reflect the $100 million properly classified as preferred at a zero cost.

DISCUSSION AND ANALYSIS

The only issue in this proceeding is whether the rate of return claimed by United for the separate locked-in period involved in this case is excessive or unreasonable. The question presented involves both factual analysis and the exercise of judgment by the Commission, for a fair and reasonable rate of return is represented by a zone rather than a point. *Montana-Dakota Util. Co.* v. *Northwestern Public Service Co.*, 341 U.S. 246, 251 (1951). Under traditional rate of return analysis, "it is important that there be enough revenue not only for operating expenses but also for the capital costs of the business." *F.P.C.* v. *Hope Natural Gas Co.*, 320 U.S. 591, 603 (1944). Under the rate of return sanctioned in this Opinion, therefore, United will be required to support the capital costs of its business. Our principal factual concern, then, is determining United's capital *costs* during the pertinent locked-in periods.

The concept of "capital cost" is central to the dispute in this case. Commission staff and others argue forcefully that United actually experienced no capital cost upon nearly one-quarter of its total outstanding capital for a period exceeding two years. The Presiding Judge apparently rejected this argument, but he did find that United had twice recovered its proved capital cost for maintaining the $100 million portion of its outstanding capital. Based on this factual finding, the Judge concluded that United should refund all excess collections in this regard to its ratepayers.

I. United's Preferred Stock Obligation

During the pertinent locked-in period involved in this case, United at all times maintained a preferred stock obligation, at a nominal rate of 9.75% per annum, to its former parent, Pennzoil. United collected this cost from its customers under the suspended rates herein considered, and paid

out to the preferred stockholder all reimbursements of this reputed cost received from the customers. Subsequently, by virtue of the Spin-off Settlement agreement, United was repaid for all preferred stock dividends proffered and the preferred stock issuance was cancelled. This subsequent transaction left United with approximately $15 million, which had been collected through its rates in order to satisfy its then-obligation to pay preferred stock dividends. The question in this case is what was United's actual embedded cost of the $100 million of preferred stock?

During the locked-in period involved in this case, United had a fixed, and undisputed, amount of outstanding capital available to the company to support jurisdictional service. A portion of this capital was in the form of debt securities and a portion in the form of common equity. The remainder — nearly one-quarter of the whole amount — was classified during the locked-in period as preferred stock with a nominal cost of 9.75% per annum.

Investors who were purchasing United's common stock on the open market during the locked-in period were aware of United's capital structure and were therefore expecting to earn a fair return *only* on the then existing common equity of $93 million. These investors consequently have claim to only those earnings that result from a return on the $93 million of common equity which was in United's capital structure during the locked-in period.

II. Classification of $100 Million In Capital

The classification of capital, in the normal case, assists the Commission in evaluating the risk associated with such outstanding capital, all *as a means* of determining the cost of that portion of outstanding capital. The Presiding Administrative Law Judge has concluded that this $100 million of United's outstanding capital is properly classified

as preferred stock during the pertinent locked-in period, a period which coincides with the effective period of the original spin-off arrangement. This conclusion has legal significance only in respect to the risks associated with this capital during the period, thereby influencing the cost to be assigned as necessary to maintain this portion of United's capital during the pertinent period. The nominal cost of this $100 million of outstanding preferred capital was 9.75% per annum. This cost is lower than that which would be assigned to equity capital because (at least, during the pertinent period of time) those investors which originally supplied this $100 million in capital actually had a senior claim on the earnings of the utility by virtue of its classification and, accordingly, their investment was less risky than common equity investment. In addition, the purchasers of United's common stock were cognizant of the existence of this senior claim and did not expect to participate in the return that would be allowed on the preferred stock.

We find no error in the conclusion of the Presiding Judge that this $100 million of United's outstanding capital is properly classified and costed as preferred capital. The classification found appropriate by the Presiding Judge accords with the realities existent during the locked-in period involved in the instant proceeding, and it is adopted.

III. Cost of $100 Million In Capital

The classification of the controversial $100 million of United's outstanding investor capital as preferred equity during the pertinent locked-in period identifies the caliber of risk associated with this amount of United's invested capital. It also establishes the relevant guidepost for calculating an appropriate cost for maintaining this capital during the periods.

In his analysis of the cost issue the Presiding Judge begins with the conclusion that "[a]s 9.75% cumulative preferred stock, that capital presumptively had a cost to United of 9.75%." *ID*, pg. 6. This presumptive cost is the nominal preferred stock dividend on the face of the securities issued by United to Pennzoil, and was, in fact, the rate at which United was legally obligated to reimburse the preferred shareholder as long as the issuance was effective. There is no evidence whatsoever in the instant record to indicate that this 9.75% per annum rate (cost) was excessive or imprudent. No party to this proceeding argues that this assigned cost rate on preferred stock during the pertinent period was unreasonable. It is found that the cost to United for maintaining this $100 million of preferred equity capital during the locked-in period involved in this case is 9.75% per annum.

The Presiding Judge, however, ultimately ruled that this $100 million of investor-supplied capital should be reflected in United's capital structure at a zero cost rate. The Presiding Judge reasoned that United had twice recovered its legitimate 9.75% cost of maintaining this capital, and that the company should be required to refund one-half of this double recovery to its ratepayers. In order to effectuate this result, the Presiding Judge found it necessary to reflect the $100 million of capital in United's capital structure at a zero cost rate. This cost element of United's capital structure for ratemaking purposes was apparently not intended to denigrate the finding that "that capital presumptively had a cost to United of 9.75%." *ID*, pg. 6. The inclusion of $100 million at a zero cost in the rate making capitalization was intended to be a shorthand technique to reflect the fact that "United ultimately did not pay out [the experienced 9.75% cost] because of Pennzoil's return to United of the $15 million of dividends." *ID*, pg. 6. The key to the rationale of the Presiding Judge rests in the signifi-

cance implictly attached to the fact that United "did not pay out" the cost which it had recouped from its ratepayers to maintain this portion of its capital during the period involved.

MDG attempts to distinguish the "cost" of equity, which admittedly cannot be assessed on the basis of actual payout, from the other capital costs experienced by United.

> The rate of return [sic. Cost?] to be permitted on preferred stock is exactly what the *actual payout* on the preferred stock was during the locked-in period. . . . (*MDG's Br. Opp.*, pg. 7, emphasis supplied).

United's actual preferred dividend payout during the locked-in period herein involved was, in fact, at the rate of 9.75% per annum. Because the preferred stock issued was cancelled *ab initio* by the parties to the Spin-off Settlement, however, United was refunded its total dividend payout. Hence, argues MDG, there was in reality no payout and no actual cost to United whatsoever.

New York's argument in support of the result reached by the Presiding Judge is, however, entirely different. New York contends that the Commission's approval of the Spin-off Settlement voluntarily negotiated by Pennzoil, United, *et al.*, was tantamount to a Commission finding that the preferred stock *cost* actually incurred by United during the effective period of the original spin-off transaction was imprudent. Moreover, New York seems to contend that this finding of imprudent expenditure is *res judicata,* since the Commission's Spin-off Settlement Order is now final and no longer subject to judicial review.

The issue involved in the Spin-off Settlement hearings was whether the obligations created as an incident to the Pennzoil-United spin-off were consistent with the public

interest and the strictures of the Natural Gas Act. These inquiries were ultimately avoided on their merits because of the voluntary, negotiated settlement filed by the interested parties. The Commission held that the Spin-off Settlement accomplished the objective (United's spin-off) in a manner consistent with the public's interest in United's continuing financial viability without having to address the relative merits of the original spin-off transaction. There was no finding or inference by the Commission that United had been unreasonable and/or imprudent in collecting, through its filed rates, revenues sufficient to cover its experienced capital costs during the effective period of the original spin-off.

United, on the other hand, has argued that the assigned cost of 9.75% upon this portion of its capital — the very cost which United claimed as reasonable in its instant rate filing — has become unreasonably low by virtue of the Spin-off Settlement agreement. United seems to argue that the Spin-off Settlement finally established its equity ownership's legitimate claim to the realized return on this $100 million of its outstanding investor capital. Accordingly, argues United, the assigned cost for maintaining this portion of outstanding capital should be retroactively increased to reflect the risks assumed by equity investors during this period under the post-Spin-off Settlement capital structure. This argument is untenable for the *actual risk* associated with any particular increment of capital during a particular period is not a function of the investor's identity. The risk associated with United's $100 million of capital which was classified as preferred stock during the relevant period was, in fact, a preferred stock risk.

The Commission will follow the approach in this case for computing the embedded cost of preferred stock that it

follows in other rate proceedings. When computing the embedded costs of debt and preferred stock it is appropriate that the cost allowed is net of gains and losses or expenses that are associated with the particular securities. A relevant example is the reduction which is made from the cost of debt to reflect gains on the reacquisition of debt.

While United paid $15 million in preferred dividends to Pennzoil, when the Spin-off Settlement was entered into the $15 million in preferred dividends was returned to United. Hence, the net cost of the preferred stock was zero. Although this analysis of the flow of the $15 million in preferred dividends is different than that assumed by the Presiding Judge, the end result is the same.

By assigning a cost of zero to the $100 million of preferred stock, the rates charged to consumers during the locked-in period will reflect United's actual cost for the preferred stock. The consumer will obviously be the beneficiary of the return of the $15 million of preferred dividends. The common equity owner will not be affected. As discussed later in this Opinion the common equity owner will receive a fair and reasonable return on the $93 million of common equity which was in United's capital structure during the locked-in period.

In conclusion, therefore, the Commission finds that the net cost to United for the $100 million of preferred stock was –0–. We concur with the Presiding Judge in his decision to include the $100 million in the capitalization of United at zero cost. To do otherwise would provide a substantial windfall gain to the common equity owner in the form of a 25.52% return on common equity. This will be illustrated in our discussion of the cost of Common Equity.

IV. Cost of Common Equity

In the post-spin-off period, United's "new" public ownership could initially look to both United and to Pennzoil for the adequate return which they might have expected on that capital which Pennzoil had channelled to United in the pre-spin-off period. However, in the post-spin-off period United's "new" public ownership was not static; trading in United's common equity shares may have radically changed the position and expectancies of this aggregate ownership. For example, purchasers of post-spin-off equity shares in United were not conveyed a claim upon the earnings of United's former parent, Pennzoil, as an incident of such sale. Therefore to the extent that the original distributees of Pennzoil's ownership interest in United changed in the post-spin-off period, United's *cost* of common equity must reflect the objectively-determined risk associated with common equity ownership alone. There is no question that the market price of United's post-spin-off common equity reflected the investment community's assessment of such securities on their merits alone, with no consideration whatsoever given to the indirect financial interest which United's original ownership had retained through United's preferred stock obligations to Pennzoil. The Commission, therefore, is initially confronted with the threshold question of whether United's outstanding equity should be evaluated for ratemaking purposes on its own merits, separate and apart from any particular investors' indirect financial interest in United through Pennzoil common stock ownership. To avoid speculative results in this unusual case, we find that United's outstanding equity capital ($93 million) should indeed be evaluated on its own merits.

The spin-off of United's common equity, of which the capitalization during the locked-in period was a result, took place on March 14, 1974. It is important to note that from April 1974 through December 1975 (the last month of the

locked-in period) 11,806,400 shares of United's common traded on the open market. This represented a turnover of 123% of the common shares outstanding as of December 31, 1975. The key point is that over 11 million shares of United's common stock were purchased by investors who were aware that the capital structure of United consisted of approximately 52% debt, 25% preferred and 23% common equity. These investors anticipated earning and should be allowed to earn a fair and reasonable return on the $93 million of common equity that was part of United's capital structure during the locked-in period.

A. United's Book Equity

The Supreme Court in *F. P. C.* v. *Hope Natural Gas Co.*, 320 U.S. 591, 603 (1944), set forth a dual standard for determining the appropriate return to be afforded as recompense to a regulated utility's equity ownership. The first standard, the comparable earnings standard, implies that the return which the company is afforded the opportunity to earn through its filed rates must be fair to current investors in the company in comparison with alternative investments attended by similar risks. The objective, of course, is to prevent disinvestment of securities perceived in the investment community as unattractive. The second standard announced by the Supreme Court, the capital attractiveness standard, addresses the concern that the allowed return which is objectively fair to current investors be also sufficient to enable the company to procure additional capital, as needed, at a reasonable cost. Under this second standard, the particular circumstances of the regulated company become much more significant, for, as an example, a particular regulated company may require a greater return on equity in order to procure larger amounts of capital than that return which would be sufficient to attract lesser amounts of capital. In *Natural Gas Pipe Line Com-*

pany, Opinion No. 762, 55 FPC — (1976), the Commission made it clear that neither one nor the other of these dual standards could fruitfully be employed alone to test the propriety of any claimed return on common equity.

In the unusual circumstances of this case, however, the comparable earnings standard is a relatively tenuous guideline, when it is realized that United's initial public ownership did not exclusively rely upon United alone to satisfy its investment expectations. By virtue of the public trading in post-spin-off United common equity, during the locked-in period involved in this case, such ownership was gradually transformed into a group of investors which might look exclusively to United to satisfy their expectations.

The Presiding Judge, perhaps recognizing the limited application of the comparable earnings test in the context of this case, rested his conclusion as to the appropriate cost of United's common equity primarily upon the second standard (the capital-attractiveness standard) finding that a cost of common equity of 15.00% "sufficient to allow United to continue to attract capital and to maintain its financial integrity." *ID,* pg. 7. The Presiding Judge was apparently convinced that this cost of 15.00% should be applied to United's total outstanding book equity during the period, including the $15 million of "equity" contributed by Pennzoil in conjunction with the original spin-off transaction. Controlling weight was assigned to the evidence presented by Commission staff, which had revised its recommendation in this case to support a 15% return to common equity on the basis of adverse market conditions during the locked-in period involved in this case. Staff's evidentiary presentation was based on the so-called "comparable earnings" approach, an approach which principally aims at determining a comparable rate of return to other investments of the same or similar risk.

Commission staff recommends a return to United's common equity of 15.00%, based on an equity ratio of 22.92%. This recommendation reflects staff's revised judgment that adverse business conditions during the locked-in period involved in this case increased the business risks associated with an investment in United. The recommendation also reflects the Commission staff's judgment that United's "thin" equity ratio of 22.92% indicates a greater financial risk than the average of those firms' earnings used for comparative purposes. United's financial witness also recommended a return to common equity of 15.00%, albeit this recommendation was based on an equity ratio of 47.59%. In other words, United's witness suggests that that United capital which was classified as preferred stock during the locked-in period be reflected, for rate-making purposes, at a cost of 15.00% rather than its nominal of 9.75%. For reasons detailed above, this position is untenable. United's witness did not proffer a recommended return on the basis of an equity ratio of 22.92%, but on brief United suggests that a fair and reasonable cost of equity of 17.00% would be justified on the thinner equity ratio, but only if the $100 million of preferred stock were included in the capital structure at a cost of 9.75%.

United's Br., pg. 22. MDG filed exceptions to the Judge's determination that United's reasonable cost of common equity for the locked-in period is 15.00%. MDG contends that this finding lacks support in the instant record and MDG argues that a cost no greater than 14.00% is established by the record. There is no basis for this allegation in the record as only staff and United submitted expert evidence on the question.

There is a plethora of evidence in this record to indicate the historical averaged earned returns of various combinations of comparison firms, regulated and unregulated. This

data indicates the general range of alternative earnings possibilities for investors, alternatives against which United must compete in the financial markets in order to procure additional equity capital, as needed.[11] But alternative investment options are meaningless unless United's particular circumstances are given weight in evaluating what return is fair and reasonable *for United.* Proof of historical earnings, moreover, proves nothing with respect to the adequacy of historical earnings under contemporary economic and financial conditions.

The concept of risk is central. Alternative investments may be more attractive in the investment community if United's market position is particularly and uniquely vulnerable in comparison with other firms. There are several factors evidenced on the instant record which indicate that an investment in United during the locked-in period in this case was more risky than generally comparable investments, indicating United's need for a greater return to common equity in order to maintain its financial integrity in the capital markets.

United's current supply outlook is difficult. Added to this principal risk factor is the fact that adverse economic conditions prevailed during the locked-in period involved in this case, another source of increased business risk which mandates adjustment of historical data of comparable

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[11] *Compare,* the "Comparative capital structures" for 1975 set forth in Exhibit No. 16, and the averaged earned rates of return for the same group (Exhibit No. 18), with United's claimed return of 15.00-17.00% upon an equity ratio of 22.92% or 47.59%. Commission staff's witness provided evidence which generally corroborates that produced by United. *See,* Exhibit No. 22, pg. 14. On the whole the evidentiary record tends to indicate a reasonable and fair range of equity earnings from 14.00% to something in excess of 15.00%.

earnings in light of United's unique circumstances. Finally, the actual impact of the Pennzoil-United spin-off arrangement upon the United's financial position must be considered. The Commission's concern in this respect was serious enough to have led to the Commission's investigation of the spin-off arrangement. Because the original spin-off transaction was effective during the entire locked-in period involved in this case, it is clear that those financial risks associated with investment in United's common equity under the regime of the original spin-off were much greater than those associated with investments in other enterprises during the period. Each and every factor which increased the risk associated with investment in United during the locked-in period argues for an allowed return to common equity during the instant locked-in period which is greater than alternative investment earnings.

Based on a common equity ratio of 22.92%, the Commission finds a rate of return of 15.00% fully justified by the evidentiary record as within that zone of reasonableness defining a balance of all relevant factors. We emphasize, however, that this judgment is based on factors pertinent to the locked-in period involved in this case. In subsequent periods, after the Spin-off Settlement was implemented, the increased risks which prevailed during the instant locked-in period either evaporated (as in the case of the increased financial risks stemming from a thin equity ratio) or were moderated. In any event a fair and reasonable return allowance for United in subsequent rate proceedings must be evaluated on the basis of factors then pertinent. Subsequently good fortune, however, cannot be utilized to deprive United of a fair and reasonable return allowance in the rates effective during a period of prevailing uncertainty and substantially increased risk.

We find that a return to common equity of 15.00% is not only required out of fairness to the then-current United investors but also, as that return allowance which was necessary to insure United's financial integrity and assure an ability to attract additional capital. The Spin-off Settlement was a valuable instrument in aid of assuring United's *prospective* financial viability and capital attractiveness. This Agreement's effectiveness, however, did not and could not affect investment decisions during the effective period of the instant rates. The terms of the Spin-off Settlement, in any event, do not obviate the Commission's responsibility to provide earnings which insure fiscal integrity, earnings defined by the rates effective during the locked-in period.

Consideration must be given to the very beneficial effect that the Spin-off Settlement had on the investors who purchased over 11 million shares of United's common stock during the locked-in period. Those stockholders invested in United expecting to earn a fair rate of return that would be generated by the $93 million of common equity in United's capitalization. Not only are they going to earn a fair return, but they have also experienced a windfall gain in the form of an $85 million increase in the book value of their investment.[12] This represents a windfall gain of 91%.

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[12] Cancellation of preferred stock ..... $100 million
less return of Pennzoil's capital contribution ..... −15 million
net increase in book value ..... 85 million

The Commission finds that the following capitalization and returns are just and reasonable:

	Amount (000's)	Ratio	Cost	Weighted Cost
Long-Term Debt	$212,487	52.41%	7.92%	4.15%
Preferred Stock	100,000	24.67	–0–	–0–
Common Equity	92,910	22.92	15.00	3.44
	$405,397	100.00%		7.59%

As stated previously, if a 9.75% cost for the preferred stock were to be allowed, the common equity owners of United would receive another windfall gain in the form of an exorbitant 25.52% return on their common equity.[13] Since the preferred dividends were returned to United, the embedded cost of the preferred stock was actually zero. If the rates charged to the consumers included an allowance for a 9.75% cost for preferred stock, the dollars generated by such a charge would flow through to benefit the common equity investors.

The common equity investors benefited by a 91% increase in their book value and the consumers will benefit by our

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	Amount (000's)	Ratio	Cost	Weighted Cost
Long-Term Debt ..	$212,487	52.14%	7.12%	4.15%
Preferred Stock ...	100,000	24.67	9.75	2.41
Common Equity ...	92,910	22.92	15.00	3.44
	$405,397	100.00%		10.00%
Long-Term Debt ..	$212,487	52.14%	7.12%	4.15%
Preferred Stock ...	100,000	24.67	–0–	–0–
Common Equity ...	92,910	22.97	25.52	5.85
	$405,397	100.00%		10.00%

applying a zero cost to the preferred stock. We believe that the results represent a fair and reasonable sharing between the consumers and the investors of the benefits of the Spin-off Settlement.

B. Pennzoil's Capital Contribution

The Spin-off Settlement provided for United to return to Pennzoil the $15 million capital contribution which Pennzoil made to United at the time of the original spin-off. In order to be consistent and treat the common equity owners of United fairly we find that the $15 million Pennzoil capital contribution should be left in the common equity used to determine the rates of return in this proceeding.

The purchasers of over 11 million shares of United's common stock during the locked-in period anticipated earning a fair return on the $93 million of common equity which existed in United's capital structure. In our judgment there is no basis for allowing a return on any lesser amount.

The Commission finds:

(1) United had available during the locked-in period involved in this case $100 million of capital that was at all pertinent times properly classified as preferred stock, having a nominal cost to United of 9.75% per annum.

(2) Pennzoil's subsequent return of all paid preferred stock dividends resulted in an actual embedded cost to United of zero.

(3) Upon an equity ratio of 22.92% during the instant locked-in period, a 15% cost of common equity is fair, reasonable and necessary to maintain United's financial integrity.

(4) The $15 million of United's book equity attributable to Pennzoil's capital contribution, subsequently cancelled

and returned by United, is properly includable in United's common equity for rate making purposes.

The Commission orders:

(A) Upon all of the evidence in the instant record United is entitled to an overall rate of return of 7.59%.

(B) Within 80 days of the issuance date of this Opinion, United shall file with the Commission revised tariff sheets reflecting the mandate of this order and, simultaneously, shall make appropriate refunds to its ratepayers, according to the negotiated terms of the settlement agreement governing the hearing of the reserved rate of return issue in this case (*see* hearing Exhibit No. 1).

(C) Within 80 days of the issuance of this Opinion, United shall file with the Commission revised tariff sheets in Docket Nos. RP74-20 and RP74-83 to reflect the mandate of this order and, simultaneously, shall make appropriate refunds to its ratepayers according to the terms of this order at the rate of interest prescribed in Opinion Nos. 815 and 815-A.

By the Commission. Commissioner Sheldon voted present.

(SEAL)

KENNETH F. PLUMB
Secretary

UNITED STATES OF AMERICA

FEDERAL ENERGY REGULATORY COMMISSION

UNITED GAS PIPE LINE COMPANY	DOCKET NOS. RP75-30, RP74-20, RP74-83

ERRATA NOTICE

(September 20, 1978)

OPINION No. 16

(Issued July 3, 1978)

The capitalization and return table appearing on page 22 should be corrected to read as follows: (The corrected figures are marked by asterisk)

	Amount (000's)	Ratio	Cost	Weighted Cost
Long-Term Debt	$212,487	52.41%*	7.92%*	4.15%
Preferred Stock	100,000	24.67	–0–	–0–
Common Equity	92,910	22.92	15.00	3.44
	$405,397	100.00%		7.59%

Footnote 13, also appearing on page 22, should be corrected to be read as follows: (The corrected figures are marked by asterisk)

	Amount (000's)	Ratio	Cost	Weighted Cost
Long-Term Debt	$212,487	52.41%*	7.92%*	4.15%
Preferred Stock	100,000	24.67	9.75	2.41
Common Equity	92,910	22.92	15.00	3.44
	$405,397	100.00%		10.00%
Long-Term Debt	$212,487	52.41%*	7.92%*	4.15%
Preferred Stock	100,000	24.67	–0–	–0–
Common Equity	92,910	22.92*	25.52	5.85
	$405,397	100.00%		10.00%

KENNETH F. PLUMB
Secretary

Appendix D

UNITED STATES OF AMERICA
FEDERAL ENERGY REGULATORY COMMISSION

Before Commissioners:
CHARLES B. CURTIS, *Chairman;*
DON S. SMITH, GEORGIANA SHELDON,
MATTHEW HOLDEN, JR., AND GEORGE R. HALL.

UNITED GAS PIPE LINE COMPANY	DOCKET NOS. RP75-30, RP74-20, RP74-83

ORDER DENYING REHEARING

(Issued April 5, 1979)

On August 2, 1978, United Gas Pipe Line Company filed an application for rehearing of Opinion No. 16, issued July 8, 1978. Opinion No. 16 affirmed in part the Initial Decision of Judge Allen C. Lande issued October 14, 1977.[1]

Upon review, the Commission finds that no facts or principles of law have been shown which would warrant any modification of the Opinion issued July 3, 1978.

It is appropriate to correct arithmetical errors appearing in the capitalization and return tables appearing on page 22 of Opinion No. 16. The Long-Term Debt Ratio should be 52.41, the Long-Term Debt Cost should be 7.92% and all Common Equity Ratios should be 22.92. No other adjustments to the numbers on the tables are required by this correction.

Accordingly, the application for rehearing is denied.

By the Commission.

(SEAL)

KENNETH F. PLUMB
Secretary

[1] An "Order Granting Rehearing for Purposes of Further Consideration" was issued on August 29, 1978.